The Macro
Research Desk

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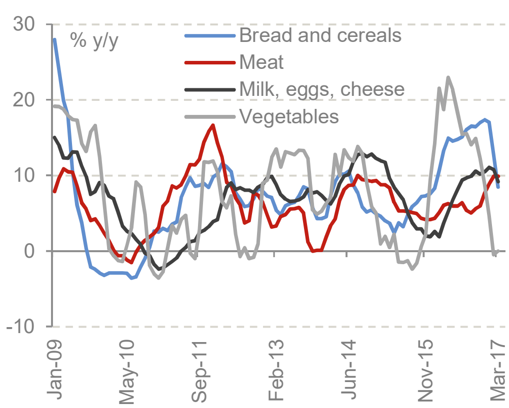
# Headline inflation beats expectations at 6.1% in March 2017

**Headline inflation beats expectations of 6.4% year-on-year (y/y), printing at 6.1% y/y in March 2017**

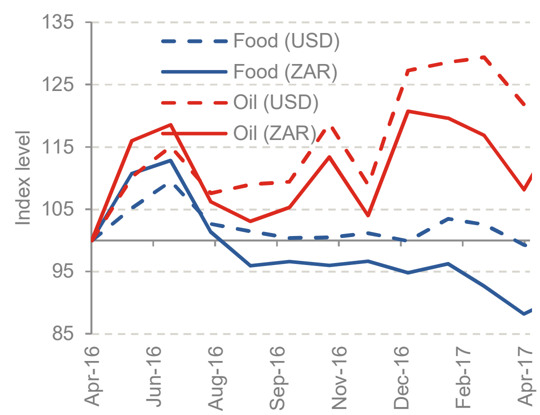
Headline consumer price inflation (CPI) decelerated from 6.3% y/y in February to 6.1% y/y in March 2017, but increased by 0.6% in month-on-month (m/m) terms on the back of a hike in education (7% m/m) and rental (1.1% m/m) costs. March 2017 is generally a high survey month, with around 43% of the basket being reviewed after taking account of the usual monthly surveys. Relative to our own forecasts, prices of alcoholic beverages, tobacco products, owner's equivalent rental and public transport surprised to the downside. In particular, larger price increases were expected for alcoholic beverages and tobacco in response to the sin taxes announced in the February 2017 national budget. As such, Momentum Investments expects further price pressure in these two components in the April 2017 CPI print.

**Chart 1: Meat partly offsetting lower bread inflation**




*Source: Stats SA, Global Insight, Momentum Investments*

**Chart 2: Global food prices in rand terms are favourable**




*Source: Stats SA, Global Insight, Momentum Investments*

**Food disinflation trend intact**

Food inflation averaged 10.8% y/y in 2016, declining to 9.5% y/y on a year-to-date basis in 2017 and printing at 8.7% y/y in March 2017 (see chart 1). Momentum Investments expects a further fall in food inflation in upcoming months owing to an improvement in weather conditions, boding well for bread and cereal prices which dipped 0.6% in the month to 8.5% y/y.

The Crop Estimate's Committee projects this year's maize harvest to be nearly double the levels achieved in 2016, pointing to lower grain prices. Global food prices are more or less in line with where they were a year ago (see chart 2). However, translated into rand terms, food prices are around 9% lower than the corresponding period in 2016, providing an additional tailwind for food disinflation this year. Nevertheless, this disinflationary trend is likely to be partly offset by a continued rise in meat prices (currently registering at 9.9% y/y). According to the SA Reserve Bank's April 2017 Monetary Policy Review, beef prices are likely to be sustained at higher levels due to herd rebuilding, while an outbreak of avian influenza in Europe and brining regulations (to reduce the amount of salt water that may be injected into chicken) could keep chicken prices high.

The drop in food inflation has aided a recovery in headline inflation for lower expenditure deciles which allocate a larger portion of spend on food. Headline inflation for the three lowest expenditure deciles decreased from 6.8% in February to 5.7% y/y in March 2017. Meanwhile, inflation for the three highest expenditure deciles tracked sideways at 6.2% y/y over the corresponding period.

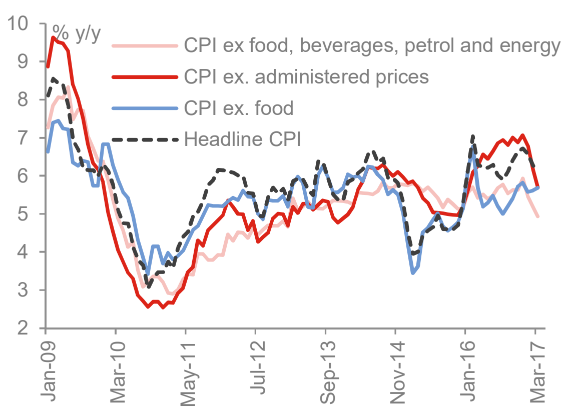
**Politically-driven rand weakness could result in a sizeable May 2017 petrol price increase**

An 8c/l drop in petrol prices in March 2017 drove private transport costs down by 0.5% m/m. A further 20c/l cut is expected to provide some relief in April 2017 (taking account of a fuel price drop which was partly offset by a 30c/l increase in the general fuel levy and a 9c/l increase in the Road Accident Fund (9c/l) levy). Recent adverse movements in the rand are pointing to a 55c/l under-recovery in the fuel price for May 2017.

**Underlying measures of inflation ease further**

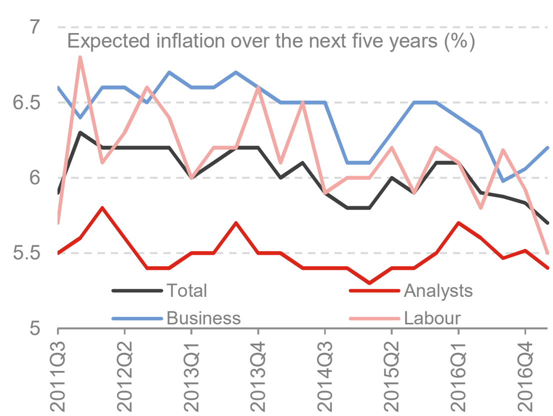
Core inflation (headline excluding food, beverages, petrol and energy) decelerated to 4.9% y/y in March 2017 from 5.2% y/y in February, markedly lower than the 5.6% y/y average recorded over the past twelve months (see chart 3). Momentum Investments anticipates that core inflation will average around a similar level over the next twelve months. Disinflation in core goods has largely been responsible for the downward trend in overall core inflation, while core services inflation has persisted at higher levels. Although core prices are expected to remain below 5% in upcoming months, the lower rate of currency pass-through observed recently suggests that inflation may not experience the full benefit of previous rand strength.

**Chart 3: Core inflation eases further**




*Source: BER, Momentum Investments*

**Chart 4: Survey-based inflation expectations**




*Source: BER, Momentum Investments, data up to 2017Q1*

**Limited room to cut interest rates**

Bar a temporary dip below 6% in August 2016, headline inflation has exceeded the SARB's official 3% - 6% target since January 2016. Nonetheless, Momentum Investments expects inflation to ease from current levels as food disinflation and previous currency tailwinds provide further inflation relief in upcoming months. Despite disruptive politics triggering a sovereign downgrade to sub-investment grade by Standard and Poor's (S&P) Global Ratings and Fitch Ratings, the rand continues to trade as the third best performing currency on a one-year rolling basis, when compared to a basket of emerging market (EM) currencies. Robust Chinese data and a sustained appetite for global commodity prices (at the time of writing, the Bloomberg Commodity Price Index is nearly 18% higher than the trough reached in January 2016) have provided support for EM currencies in general, but have specifically buoyed currencies belonging to net commodity-exporting EMs. The United States (US) Federal Reserve's (Fed) resolve to normalise interest rates in a gradual manner should also prevent a more adverse effect on EM currencies, including the rand.

However, rand risks remain to the upside. Should higher growth and a sharper rise in inflation elicit a stronger response from the US Fed, a sharper reversal in capital outflows could transpire across EMs. Although SA's current account deficit narrowed considerably in the fourth quarter of 2016, it is expected to widen again over the course of 2017, leaving the country vulnerable to investor sentiment, given SA's reliance on foreign capital flows to fund the deficit on the current account.

Similarly, the rand could weaken in an environment of increased trade barriers resulting from a more protectionist US stance. Momentum Investments expects the rand to remain volatile into year end, on the back of uncertain domestic politics, in the lead up to the African National Congress (ANC) National Executive Committee (NEC) meeting to be held in December 2017.

The SARB has further noted that SA's inflation persistently tracks above global and EM averages, highlighting inherent wage and price rigidities which feed on elevated inflation expectations. Though the Bureau of Economic Research's (BER) Inflation Expectations Survey, for the first quarter of 2017, shows a slight improvement in inflation expectations over the next five years, expectations remain uncomfortably close to the upper end of the inflation target (see chart 4). The SARB has admitted that "while the stability of expectations has been reassuring in the context of above-target inflation, it would be preferable for expectations to be anchored more centrally within the inflation target range". Even though Momentum Investments projects inflation to reach close to 5% on average in 2018, the above arguments limit the scope for interest rate cuts. The recent downgrades to junk status by S&P and Fitch ratings agencies and ongoing political noise have raised the risk of higher inflation and lower growth. As such, Momentum Investments expects the SARB to maintain interest rates at the current 7% level in upcoming quarters.

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